Chapter V

Affiliate Transactions

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Background

The FCC first addressed affiliate transactions in the order issued February 6, 1987 in Docket No. 86-111. Affiliate transaction rules established in this docket are codified in Parts 32 and 64 of the Code of Federal Regulations (CFR). Part 64 establishes the rules for the allocation of costs between regulated and non-regulated activities. In addition, Part 64 contains the requirement for filing a cost allocation manual, which identifies the terms, frequency and nature of transactions with affiliates.

CFR Part 32, the Uniform System of Accounts (USOA) for Telephone Companies, establishes the rules relating to accounting for transactions with affiliates. Section 32.23, *General Instructions*, provides guidelines for the accounting classification of items as regulated or non-regulated. Section 32.27, *Transactions With Affiliates,* provides specific rules regarding the pricing and determination of the amounts to be recorded for the various transactions.

Ameritech procedure AM 237, *Outline of Procedures for Interentity and Other Miscellaneous Billing*, provides detailed written guidelines for determining the amounts to be charged by the Ameritech Operating Companies (AOCs) to both regulated and non-regulated affiliates. There are five pricing methods available which are summarized in the Ameritech Cost Allocation Manual (ACAM) as follows:

- **Tariffed Rates**. For services provided pursuant to rates approved by State or Federal regulatory authorities.

- **Publicly Filed Agreements (PFA)**. Charges appearing in PFAs submitted to a State Commission when tariff rates are not available.

- **Prevailing Price (PP)**. The price at which the Company offers an asset or service to the general public. For example, cellular service offered to affiliates is to be offered at the price such service is offered to the public. To qualify, sales to third parties must be more than 50 percent of total activity.

- **Fair Market Value (FMV)**. The price at which the asset or service would change hands between a willing buyer and seller.

- **Fully Distributed Cost (FDC)**. Includes direct, indirect and shared costs with overheads applied using appropriate loading factors. (AI loading factors are analyzed in Exhibit AT-4).

Part 32 rules as they apply to Ameritech are summarized in Exhibit AT-1 on the page that follows.

Exhibit AT-1
Part 32 USOA, Section 32.27
Pricing Guidelines for Transactions with Affiliates

Activity	Recorded/Billed at:
Asset Transfer with: • Tariff Rate Available • Prevailing Price Available	 • Tariff Rate • Prevailing Price
Asset Transfer without Tariff Rate or Prevailing Price Available: • From AOC to Affiliate • To AOC from Affiliate	 • Higher of Fair Market Value or Net Book Cost • Lower of Fair Market Value or Net Book Cost
Service Provided with: • Tariff Rate Available • Publicly Filed Agreement Available • Prevailing Price Available	 • Tariff Rate • Publicly Filed Agreement • Prevailing Price
Service Provided without Tariff Rate, PFA or Prevailing Price: • From AOC to Affiliate • To AOC from Affiliate • To AOC from Corporate Affiliate[i]	 • Higher: Fair Market Value or Fully Distributed Cost. • Lower: Fair Market Value or Fully Distributed Cost. • Fully Distributed Cost.

There are four principal types of affiliate transaction costs:

- **Primary Costs.** These can be either Direct Costs or Indirect Costs. Direct Costs generally include salary and wages, benefits, rents and other expenses attributable to personnel performing the work. Indirect Costs consist of the applicable loadings applied to direct costs. The development of these loadings is documented in Ameritech practice AM 328, *Billing Loading Rate Development.* The type of loading applied to the bill depends on the USOA account from which billed amounts are extracted.

- **Corporate Operations Costs.** Corporate Operations costs are management, financial and other expenses incurred for the general management and administration of the business as a whole. These costs are incurred for the benefit of all, and in most instances are not directly related to any one function. Accordingly, Corporate Operations costs are billable as a loading to primary costs.

- **Investment Related Costs**. Generally, Investment Related Costs are loadings to direct costs designed to recover applicable Network and General Support and Administration Expenses that are not directly charged or otherwise cleared to the appropriate accounts.

[i] Exists solely to provide services for the corporate family.

Investment related costs include Return on Net Investment, Miscellaneous Taxes, Depreciation and Amortization expense, Maintenance costs, Network Power, Network Administration, and Testing expenses.

- **Overhead and Other Loadings.** Costs that are not direct or supporting are classified as overhead. These include Gross Receipts Tax, Motor Vehicle, Aircraft, Garage Work Equipment, Land & Building, and Office Equipment. A loading is also developed for a "float charge" to cover the use of working capital. For billing, these loadings are applied to direct costs.

Ameritech regularly enters into transactions with non-regulated affiliates to provide or receive services. These transactions are outlined in the ACAM. Ameritech Illinois billings to and from affiliates during the first quarter 2000 are shown in Exhibit AT-2 on the two pages that follow. The highest costs are for services from Ameritech Services Inc. (ASI) which provides operational support and centralized purchasing for the AOCs, and SBC Management Services (MSI) which provides various administrative and support services for the parent holding company and SBC subsidiaries.

Exhibit AT-2
AI First Quarter 2000 Affiliate Charges
(Dollars in Thousands)

AMOUNTS LESS THAN $100,000 ARE CONFIDENTIAL

Non-Regulated Affiliate	Service	Billing to AI from Affiliate	Billing by AI to Affiliate
Ameritech Advanced Data Services (AADS)	AADS provides business customers with advanced data communications services.	$756	$12,791
Ameritech Communications, Inc. (ACI)	When authorized, this subsidiary will provide in-region interLATA telecommunications services.	267	2,108
Ameritech Corporation (AIT)	The holding company for the AOCs and subsidiaries that are primarily engaged in the provision of communications products and services. It exists solely to provide services to members of the Ameritech corporate family.	5,694	1,082
Ameritech Credit Corporation (ACC)	ACC is a provider of capital financing and leasing services.	4,311	(redacted)
Ameritech Data Network Solutions (ADNS)	Provides data network design, marketing and consulting services.	(redacted)	(redacted)
Ameritech Information Industry Services (AIIS)	Provides information services to third-party information providers.	(redacted)	(redacted)
Ameritech Information Systems (AIS)[i]	Furnishes telecommunications and systems integration products and operates divisions which sell and service voice and data systems for business use.	11,700	3,747
Ameritech Interactive Media, Inc. (AIM)	A wholly owned subsidiary of Ameritech Publishing, Inc. which provides electronic yellow pages publishing services.	(redacted)	(redacted)
Ameritech Interactive Media Services, Inc. (AIMS)	A wholly-owned subsidiary of Ameritech Publishing, Inc. controlling Ameritech's delivery, sales, marketing, development and strategy of its Internet products and services.	(redacted)	191
Ameritech International, Inc. (AII)	Responsible for developing business opportunities for Ameritech outside of the United States.	(redacted)	(redacted)
Ameritech Mobile Communications, Inc. (AMCI)	Provides wireless communications services to its customers, including cellular and digital mobile telecommunications services and equipment and paging products and services.	515	4,216
Ameritech New Media, Inc. (ANM)	Provides customers with cable television services.	(redacted)	2,041

[i] Effective January 14, 2000 AIS became SBC Global Services, Inc.

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AI First Quarter 2000 Affiliate Charges
(Dollars in Thousands)

AMOUNTS LESS THAN $100,000 ARE CONFIDENTIAL

Non-Regulated Affiliate	Service	Billing to AI from Affiliate	Billing by AI to Affiliate
Ameritech Publishing, Inc. (API)	Directory advertising and publishing.	(redacted)	690
Ameritech Services, Inc. (ASI)	ASI provides the AOCs with operational support and centralized purchasing services that can most efficiently be delivered by a single organization. ASI is an affiliate existing solely to provide services to members of the AOCs corporate family.	92,575[i]	5,681
Clover Technologies (CT)	Integrator of data and video technologies.	(redacted)	(redacted)
DonTech (DT)	A partnership between Reuben H. Donnelley Corporation and Ameritech Publishing of Illinois, Inc. (a subsidiary of Ameritech Publishing, Inc.) which performs directory advertising and publishing services for Illinois.	(redacted)	(redacted)
National Telecommunications Alliance, Inc. (NTA)	Provides the AOCs with centralized national security and emergency preparedness and network interoperability and interconnectivity services.	226	(redacted)
SecurityLink from Ameritech (SLA)	Provides customers with remote electronic security monitoring services.	(redacted)	(redacted)
Starline Insurance Company (SIC)	Insurer for general liability, automobile, compensation insurance coverage and a direct writer of insurance for excess liability. SIC is an affiliate existing solely to provide services to members of the AOCs' corporate organizations.	261	(redacted)
SBC Management Services, Inc. (MSI)	MSI provides various administrative and support services for the parent holding company and other subsidiaries.	27,566	(redacted)
SBC Operations, Inc.	Provides for the planning, development, sale and merchandising of telecommunications services and products.	8,346	(redacted)
SBC Services, Inc. (SBS)	SBS performs transaction processing functions including billing, payroll, accounts payable, customer remittance, fixed asset record keeping and general ledger processing.	1,825	(redacted)
Southwestern Bell Mobile Systems, Inc. (SBMS)	Provides wireless services to the AOCs at prevailing price.	1,549	(redacted)

Source: ACAM Section V and Document Request WJD 2-6.

[i] Includes Ameritech Center Phase 1, a wholly owned subsidiary of ASI

Objectives

- Determine whether affiliate transactions are supported by service agreements and are properly summarized in the ICAM.
- Determine whether affiliate transactions are priced in accordance with FCC regulations.
- Determine whether there are material unrecorded and unreported affiliate transactions.

Evaluative Criteria

- Does the ICAM contain a complete and accurate listing of AI affiliates and properly summarize transactions by the costing methodology used?
- Are SBC and Ameritech procedures adequate to ensure that allocations affecting regulated companies are adjusted when new non-regulated affiliates are formed or acquired and begin to receive corporate services?
- Are affiliate transactions supported by service agreements in accordance with FCC and ICC requirements?
- Are affiliate transactions priced in accordance with FCC regulations?
- Are procedures adequate to reasonably ensure that there are no material unrecorded or unreported affiliate transactions?
- Are there other issues with respect to affiliate transactions of potential interest to the Commission?

Summary of Audit Procedures

- Reviewed relevant SBC and Ameritech documents including:

  ⇒ Cost allocation manuals
  ⇒ Cost allocation procedures
  ⇒ Affiliate Service Agreements
  ⇒ PCAS documentation (PCAS is an acronym for Ameritech's Part 64 Cost Allocation System)

- Examined the methodology for allocating affiliated charges to AI for each affiliate.
- Tested selected charges to AI from affiliates, including new SBC affiliates.
- Tested selected charges from AI to affiliates.
- Tested selected affiliate transactions to verify pricing methods and billing.

- Interviewed appropriate SBC and Ameritech personnel including the Team Lead for Regulatory Compliance and the Manager of Part 64 Standards.

Findings and Conclusions

1. Ameritech has adequate internal controls to provide reasonable assurance that affiliate transactions are accounted for in accordance with FCC and Commission requirements.

   - As reported in Chapter IV, Internal Controls, Ameritech currently has an appropriate, experienced organization in place to manage the cost allocation process and ensure CAM compliance. Many of these same individuals are also involved in the assurance of compliance with the FCC Affiliate Transaction Rules.

   - Ernst & Young, LLP (E&Y) performed an extensive audit of the 1999 cost allocation process that included testing of affiliate transactions. E&Y expressed an opinion that in all material respects Ameritech's FCC Report 43-03 fairly presents its compliance with FCC Rules, including Sections 32.23 and 32.27, which relate specifically to affiliate transactions.

   - Ameritech has detailed written procedures for determining amounts to be billed by the AOCs to affiliates. These procedures are outlined in AM 237, *Outline of Procedures for Interentity and Other Miscellaneous Billing*. These procedures provide reasonable assurance that there are no material unrecorded or unreported affiliate transactions. However, as discussed further in Finding 10, these procedures have not been updated since 1989 and do not reflect changes following the merger.

2. BWG's review of 1999 affiliate charges to AI indicates that transactions are priced in accordance with FCC regulations. Exhibit AT-3 at the end of the text in this numbered paragraph summarizes billings from affiliates to AI in 1999. This exhibit identifies the billing affiliate, describes the services provided, and shows the annual charges and the pricing basis.

   - Ameritech Services (ASI) billings constitute 77 percent of affiliate billings to AI and are made based on Fully Distributed Costs (FDC) in accordance with FCC rules which allow affiliates that exist solely to provide services for the corporate familyto use FDC. Affiliates of this type include ASI, AIT, SIC, SBS, SBO, and MSI. BWG's review of the billing process employed by ASI indicates that the pricing methodology is correct.

   - Ameritech Information Systems (AIS) is the largest supplier of services priced on the basis of Fair Market Value (FMV). We determined that Ameritech used an appropriate pricing method for billings by AIS to AI of $41.5 million in 1999.

     ⇒ AIS charges AI monthly on the basis of FDC and performs a FMV study each November to determine whether FMV or FDC produces a lower cost to AI for marketing services. BWG reviewed the 1999 study and confirmed that FMV was the lower, and therefore proper method.

⇒ In December 1999, the Company appropriately recorded a journal entry for \$5.3 million to adjust for the change between the application of the FDC and FMV pricing methodologies.

⇒ During the first quarter 2000, AIS charged AI \$3.9 million monthly based on FDC estimates. The November 2000 study will determine if FMV is lower than FDC. If necessary, an adjustment will be made in December to reduce expenses.

- ASI charges to the AOCs have not been independently audited by a regulatory commission since 1995. The 1995 audit was performed by an FCC Joint Audit Team including the Public Utilities Commission of Ohio and the Public Service Commission of Wisconsin and focused on 1992 transactions. The audit objectives were to evaluate compliance with the affiliate transactions rules and to determine whether any noncompliance with these rules had adversely affected telephone ratepayers through the flow of cross-subsidies to non-regulated affiliates.

Exhibit AT-3
1999 Billings from Affiliates to AI
(Dollars in Thousands)

AMOUNTS LESS THAN \$100,000 ARE CONFIDENTIAL

Billing Affiliate	Services Provided	Amount	Pricing Basis
Ameritech Services (ASI)	Corporate: Legal, HR, External Affairs, Accounting, Executive, etc.	\$ 505,155	Fully Distributed Cost (FDC)
Ameritech Corporate (AIT)	Corporate, Marketing	76,778	FDC
Ameritech Information Systems (AIS)	Marketing	41,502	Fair Market Value (FMV)
Ameritech Mobile Communications (AMCI)	Paging and Wireless	8,570	Prevailing Price (PP)
Ameritech Center Phase I (ACPI)	Space Rental	694	FMV
Starline Insurance Company (SIC)	Insurance	218	FDC
Ameritech Publishing (API)	Advertising	482	PP
Ameritech Communications (ACI)	Official Communications, Teleconferencing	1,848	FMV \$ 156 FDC \$1,692
Ameritech Advanced Data Services (AADS)	Frame Relay Switching, Remote Client Server	2,808	FDC
Ameritech Credit Corporation (ACC)	Leasing of Office Equipment and Motor Vehicles	15,333	PP \$ 2,460 FMV \$12,873
Ameritech New Media (ANM)	Loaned Employees	(redacted)	FDC
Security Link from Ameritech (SLA)	Security Monitoring	590	PP
National Telecommunications Alliance (NTA)	Security, emergency preparedness, interconnection, etc.	614	PP
Total		\$ 654,609	

Source: Document Request WJD 2-6, page 59 and WJD 1.1.

3. The Company properly developed and applied loading rates in the determination of Fully Distributed Costs in 1999. Loading rates are added to direct charges to recoup indirect costs, overheads, and support costs that are not charged directly.

   - The Company has a detailed practice for the development of loading rates: AM 328 *Billing Loading Rate Development.* The rates are developed using the Ameritech Rate Development System (ARDS).

   - Exhibit AT-4 shows the items for which loadings are calculated and to which series of USOA Accounts they are applied.

Exhibit AT-4
Summary of Ameritech's FDC Loading Rate Factors

Type of Loading	Description	USOA Accounts Charged					
		21xx	22xx to 24xx	61xx	65xx	66xx	67xx
Ancillary	Float, Gross Receipts tax	Yes	Yes	Yes	Yes	Yes	Yes
Corporate	Legal, HR, etc.	Yes	Yes	Yes	Yes	Yes	Yes
Indirect	Engineering, Plant Ops. Provisioning	No	Yes	No	Testing Only	Provision -ing Only	Provision -ing Only
Overhead-Investment Generated	Capital Stock, Depreciation, Prop Tax, ROI	Yes	Yes	Yes	Yes	Yes	Yes
Overhead-Investment Related	General Support Assets	Yes	Yes	Yes	Yes	Yes	Yes

Source: Ameritech Fully Distributed Costing Overview (Document Request WJD 1.8)

   - The specific set of loading factors used depends on the primary expense being billed, i.e. plant specific (61xx), plant non- specific (65xx), customer operations (66xx), or corporate operations (67xx). For example the billing for use of support assets (Account 21xx) such as buildings, office equipment, general-purpose computers, includes capital stock, tax, depreciation, property tax, and return on investment and other overhead expenses such as legal, planning, human resources, engineering, maintenance of support facilities.

4. Referring back to Exhibit AT-3, Ernst & Young found no material exceptions relating to affiliate transactions in their audit of the 1999 ACAM.

   - E&Y tested the billings to Illinois for three non-regulated affiliates as shown below:

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Billing Affiliate	Amount Tested (Thousands)	Billing Basis

(redacted)

   - E&Y made the following observations which they determined to be immaterial:

Exhibit AT-5
Affiliate Transactions Findings
Ernst & Young Audit of 1999 (March 29, 2000)
(Dollars in Thousands)

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5. BWG's audit tests indicate that the Company has used an inappropriate method to calculate the 5 State Allocator which results in the over-charging of certain SBC and ASI costs to Ameritech Illinois.

   - There are two allocators used to bill the five individual AOCs after a total ASI bill has been tallied:

     ⇒ The *Expense Allocation Factor* is used when multiple affiliates in addition to the AOCs receive common services. It is calculated using the Total Operating Expense (TOE) of all affiliates involved.

⇒ The *5 State Allocation Factor* is used when charges pertain only to the five Ameritech AOCs. It is based on the average of TOE and Total Plant in Service (TPIS) of the five AOCs.

- The 5 State Allocator is also critical in determining the expenses AI is charged by SBC affiliates. SBC costs which are Ameritech-related are charged directly to the individual AOCs using the 5 State Allocator.

⇒ SBC began directly charging the AOCs in 2000. Exhibit AT-6 shows the amounts charged to AI by SBC affiliates during the first quarter 2000. Approximately (redacted) of the total amount billed is based on the 5 State Allocator with the trend showing increased billing from SBC affiliates as the merger transition continues.

Exhibit AT-6
SBC Billings to Ameritech Illinois
First Quarter 2000 by Month
(Dollars in Thousands)

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- BWG tested the calculation of the factors applied to billings in 2000. The Expense Allocation Factor of (redacted) for Illinois is based on 1999 annual results. The 5 State Allocation Factor of (redacted) for Illinois is based on the TOE and TPIS of the AOCs from July 1998 through June 1999.

- Ameritech's Illinois 5 State Allocator Factor (redacted) is based on an average of averages. The Company first calculates the allocation factors separately for TOE and TPIS, and then averages these two factors to determine the Illinois 5 State Factor. This methodology gives equal weight to the TOE and TPIS components. An alternative calculation methodology entails first adding AI's TOE and TPIS amounts and then dividing this sum by the five state total TOE and TPIS.

- As shown in Exhibit AT–7, AI's calculation methodology (averaging of averages) results in a factor of (redacted) for the year 2000. The alternative calculation (average of total expenditures) produces a factor of (redacted) percent for Illinois, a reduction of 0.36 percent.

Exhibit AT-7
Calculation of 5 State Allocation Factor
(Dollars in Thousands)

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Item	Expenditures		Calculated 5 State Allocator		
	AI	5 AOCs	Current SBC Methodology (Average of Percents)	Revised Methodology (Percent based on Totals)	Difference
Total Operating Expense	$ 2,765	$ 8,430	(redacted)	(redacted)	
Total Plant In Service	10,050	31,835	(redacted)	(redacted)	
Total	$ 12,814	$ 40,265	(redacted)	(redacted)	(redacted)

Source: Five State Allocator Source Data (Document Request JBM 5.4).

- The estimated impact of the use of the revised factor on charges to AI in the first quarter 2000 is $1.3 million, as shown in Exhibit AT-8.

Exhibit AT-8
Estimated Impact of Revised Allocation to Illinois
(Dollars in Thousands)

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- Although the Company states that the ASI Stockholders' Agreement supports its methodology, this is an internal document and its language is sufficiently vague so as to support both calculation methodologies. Specifically, the Stockholders' Agreement states: "Allocation factors shall be based on the average of gross telephone plant and total operating expenses for the previous year."

6. With the merger, there have been significant organizational and operational changes involving new corporate service affiliates, but allocation factors have not been adjusted to reflect these changes. Allocation factors should be reviewed periodically during the transition period and finally determined when the merger transition is complete.

   - The merger brought significant charges from new corporate services affiliates (SBS, SBO, MSI and SBMS) as well as ASI.

   - BWG's audit tests indicate that SBC affiliate charges to Ameritech Illinois in 2000 are correct based upon the allocation factors used.[i] However, the SBC/Ameritech merger transition will not be completed until mid 2001, and allocation factors need to be reviewed periodically during this transition.

   - First quarter 2000 SBC billings to its regulated operating companies are shown in Exhibit AT-9.

Exhibit AT-9
SBC Charges to Regulated Operating Companies
First Quarter 2000
(Dollars in Thousands)

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   - SBC Operations (SBO) billing to the Ameritech companies for marketing type services appears reasonable. Charges from ASI to AI indicate ASI continued to provide some marketing services in the first quarter 2000.

   - SBC Services (SBS) billing to Illinois and Ameritech is low compared to the other SBC companies since ASI continues to provide these services to Ameritech. As these services transition to SBS, we expect SBS charges to increase while ASI charges will decrease.

[i] See Conclusion 5 above for an alternative method for the development of the 5 State Allocator.

- SBC Management Services, Inc. (MSI) billing to Illinois and Ameritech is relatively high reflecting merger costs that do not pertain to the other companies.

- Southwestern Bell Mobile Services (SBMS) billing to AI appears high compared to the other companies but is comparable to 1999 charges.

  ⇒ AI currently obtains most of its wireless and paging services from SBMS.

  ⇒ Paging and wireless services provided to AI by Ameritech Mobile Communications (AMCI) in 1999 amounted to $8.6 million.

  ⇒ Total combined first quarter billing to AI from SBMS and AMCI is (redacted), or (redacted) on an annualized basis.

7. As shown in Exhibit AT-10, billings to Ameritech Illinois from other AOCs during the first quarter 2000 appear justified and are reasonable.

Exhibit AT-10
First Quarter 2000 Billing From AOCs to AI
(Dollars in Thousands)

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Source: AOC Billings to AI in 2000 (Document Request JBM 5-3).

8. Ameritech Illinois charges to affiliates in 1999 were adequately controlled and billed in accordance with FCC Rules. Ameritech Illinois charges to affiliates in 1999 are summarized by company in Exhibit AT-11 and by function and pricing method in Exhibit AT-12.

   - AI billing is controlled by a centralized billing organization utilizing the automated Billing, Collections, and Tracking System (BCATS). BCATS accumulates billable data, downloads the applicable loading rates from ARDS and issues charges to affiliates.

- Billing and Collection Services provided to Don Tech ($75.0 million) were based on a contract among AI, API, Reuben H. Donnelley, and Don Tech. This contract which provided a guaranteed revenue of $75.0 million annually expired on December 31, 1999 and was replaced by a billing and collection agreement and a listing and directory services agreement with rates based on prevailing prices. The potential impact of this change is discussed in Finding 13.

Exhibit AT-11
1999 AI Amounts Charged To Affiliates
(Dollars in Thousands)

AMOUNTS LESS THAN $100,000 ARE CONFIDENTIAL

Affiliate	Amount	Percent
Don Tech (DT)	$75,000	63.2%
Ameritech Services (ASI)	18,046	15.2%
Ameritech Advanced Data Services (AADS)	6,460	5.4%
Ameritech Information Systems (AIS)	5,566	4.7%
Ameritech Publishing (API)	3,802	3.2%
Ameritech New Media (ANM)	3,429	2.9%
Ameritech Corporation (AIT)	3,078	2.6%
Ameritech Communications (ACI)	1,239	1.0%
Ameritech Mobile Communications (AMCI)	788	0.7%
Ameritech Interactive Media Services (AIMS)	536	0.5%
Ameritech International (AII)	418	0.4%
Security Link from Ameritech (SLA)	362	0.3%
Clover Technologies (CT)	(redacted)	(redacted)
Ameritech Interactive Media (AIM)	(redacted)	(redacted)
Ameritech Credit Corporation (ACC)	(redacted)	(redacted)
Total	$118,757	100%

Source: E&Y Audit, Affiliate Transaction Tab, Section 1(A) provided in response to Document Request WJD 1-6.

- The following discusses some of the billings selected for testing and our more significant audit findings:

  ⇒ We tested the $2.2 million for Billing and Collection Services and identified no exceptions. Transaction documentation adequately supports the affiliate billing. Documentation includes volumes of services billed, service type, and the rate for that type of service. Types of services billed include casual bills rendered, messages billed, invoice bills rendered, phrase text lines, and miscellaneous. The Company provided adequate explanations for the miscellaneous billings.

  ⇒ Ameritech Illinois' Billing and Collection Service (B&C) to affiliates (excluding Don Tech) amounted to only 4.54 percent of total sales of this service. Thus Prevailing Price is the correct method for billing affiliates for this service. The majority of B&C sales are to third party inter-exchange carriers such as ATT, MCI, and Sprint.

⇒ Our review of the basis for billing Use of Motor Vehicles ($3.7 million) and Use of Physical Space ($25.6 million) identified no exceptions. The latest motor vehicle and space rental studies indicate that FMV is the appropriate rate to charge affiliates. For physical space, AI charges the average FMV of a reasonable range of rates for Chicago Downtown, Chicago Suburban, and rural areas of Illinois.

⇒ Our review of the billing and accounting for the Official Telecommunications Services that AI provides to affiliates identified no exceptions. Since these services are billed at tariff rates in accordance with FCC Rules, they are not listed in Exhibit AT-12.

Exhibit AT-12
AI Services Provided to Affiliates
(Dollars in Thousands)

AMOUNTS LESS THAN $100,000 ARE CONFIDENTIAL

Service Provided	Amount Charged	Percent	Pricing Basis
Billing and Collection (Don Tech)	$75,000	63.2%	Fully Distributed Cost (FDC)
Use of Physical Space	25,607	21.6%	Fair Market Value (FMV)
Interconnection Services	5,978	5.0%	Publicly Filed Agreement (PFA)
Use of Motor Vehicles	3,710	3.1%	FMV
Listing Services	3,686	3.1%	Prevailing Price (PP)
Billing and Collection	2,153	1.8%	PP
Installation and Maintenance	1,300	1.1%	PP
Mail Pick-Up and Delivery	376	0.3%	FDC
Telephone Answering	358	0.3%	FDC
Environment, Health, Safety	257	0.2%	FDC
Loaned Employees	225	0.2%	FDC
Employee Staffing	(redacted)	0.0%	FDC
Time Reporting for EDTP Processing	(redacted)	0.0%	FDC
Joint Marketing of Services	(redacted)	0.0%	FDC
Account Maintenance	(redacted)	0.0%	PP
Security	(redacted)	0.0%	FDC
Power Maintenance	(redacted)	0.0%	FDC
Financial and Accounting	(redacted)	0.0%	FDC
Labor Relations	(redacted)	0.0%	FDC
Centralized Processing	(redacted)	0.0%	FDC
Marketing and Sales Services	(13)	0.0%	FDC
Total	$118,757	100.0%	

Source: E&Y Audit, Affiliate Transaction Tab, Section 1 (A) provided in response to Document Request WJD 1-6.

9. As shown in Exhibit AT-13, a comparison of AI charges to affiliates in 1999 and 2000 by pricing method reveals a projected reduction in affiliate billings in the year 2000.

   - The annualized trends for billings using PFA and FMV are reasonable.

   - The reduced billing trend under FDC in 2000 is primarily due to the changes in the billing agreements with Don Tech, AI, API of Illinois, Inc. (a wholly owned subsidiary of API,Rueben H. Donnelley, and API. The Don Tech payment to AI constituted $75.0 million of the $76.3 million of FDC billing in 1999. This is discussed further in Conclusion 13.

Exhibit AT-13
AI Affiliate Billings
Annualized YTD 2000 and 1999 Total
(Dollars in Thousands)

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Basis for Billing	1999 Billing	2000 (Annualized)	Projected Change
Publicly Filed Agreements (PFA)	$5,978	(redacted)	(redacted)
Fair Market Value (FMV)	29,317	(redacted)	(redacted)
Fully Distributed Cost (FDC)	76,317	(redacted)	(redacted)
Total	$111,612	(redacted)	(redacted)

Source: 1999 and 2000 Affiliate Transactions (Document Request 2.6); BWG Analysis.

10. Elements of the Company's internal practice, AM 237, *Outline of Procedures for Interentity and Other Miscellaneous Billing*, are outdated. While we found no evidence of errors, unless practices are reviewed and updated on a regular basis, users could employ out of date procedures and produce incorrect affiliate billings.

    - Company employees follow this practice to accumulate and bill affiliates for services. Both internal and external auditors also rely upon it for an understanding of the work performed.

    - The procedure was last revised in 1989, and should be updated. For example, reference to "FASC" codes became dated with the implementation of the Ameritech Financial Information Warehouse.

11. Although Ameritech is in the process of implementing SBC *Operating Practice 125 MP, Affiliate Transactions*, the Company has concluded that no compensation is due to Ameritech Illinois relating to the exchange of Intellectual Property and Proprietary Information among companies involved in the merger.

    - Intellectual Property and Proprietary Information (IP/PI) includes material or information that could cause the company economic harm, loss, or disadvantage if it is released in an unauthorized or improper manner.

- SBC Operating Practice 125 MP addresses the IP/PI issue:

  ⇒ Section 12.14 c) provides that: " The Telco must be compensated for the IP/PI it provides that is used for other than the originating telco's benefit."

  ⇒ Section 12.16 specifies that: "The Telcos are to be reimbursed at the higher of FDC or FMV." Recognizing the difficulty in determining a market price for IP/PI, this paragraph also says that assistance of the Department's IP/PI Contract Administrator and the Affiliate Oversight Group may be required.

  ⇒ Section 12.12 prescribes the rules for "Like for Like" netting in the context of the SBC/Pacific Bell merger. It provides that Pacific Bell shall continue to own its IP/PI and permits Like for Like netting for IP/PI owned by Pacific Bell which, as part of the merger, is used in a best practice review between <u>only the regulated telephone companies</u>. (emphasis in original document)

  ⇒ IP/PI which is the subject of Like for Like netting is subject to the logging requirements described in OP 125 paragraphs 12.17-12.20.

- We have no evidence indicating that the Company is meeting the logging requirement and have been advised that an assessment of IP/PI and required documentation will not be completed until the implementation of OP 125, currently planned for completion in 2001.

- In connection with the merger, Ameritech Illinois (AI) entered into new service agreements with four SBC entities: SBC Management Services, Inc. (MSI), SBC Operations (SBO), SBC Services (SBS), and SWB Mobile Services (SBMS). With the exception of SBMS, the new service agreements contain a section pertaining to Proprietary Information.

12. Although SBC and Ameritech adopted new procedures relating to the capitalization of computer software costs for financial reporting purposes in 1999, the change was not adopted for regulatory reporting purposes until 2000.

    - In March 1998, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 98-1 providing authoritative guidance for the capitalization of certain computer software costs.

    - In June 1999, the FCC amended Part 32, System of Accounts incorporating the provisions of SOP 98-1. The FCC rules became effective six months following publication in the Federal Register which occurred on September 15, 1999. Therefore, the Company was required to adopt SOP 98-1 for regulatory accounting purposes no later that March 15, 2000. The Company adopted SOP 98-1 for regulatory accounting purposes on January 1, 2000.

    - The reason for the adoption of the new accounting method at different dates is explained by the Company in a document request response: "the SBC telephone companies did not have the mechanized accounting processes in-place to adopt SOP 98-1 for regulatory accounting purposes prior to January 1, 2000. To avoid incongruity within the SBC telephone companies (which includes the Ameritech telephone companies), the decision was made to not adopt SOP 98-1 for regulatory purposes retroactive to January 1, 1999."

13. Ameritech Illinois revenues will be significantly reduced as a result of the expiration of the Don Tech contract on December 31, 1999.

- The regulatory treatment of Don Tech revenues is discussed in the Alternative Regulation (Alt. Reg.) Order

  ⇒ The ICC Alternative Regulation Order dated October 11, 1994 states "The Commission has always included revenues from IBT's Yellow Pages in the calculation of the Company's revenue requirement."

  ⇒ In the Alt. Reg. Order, the ICC recognized the December 31, 1999 expiration date for the Don Tech contract whereby "Illinois receives a guaranteed minimum payment of $75 million per year; 7.5% of each year's incremental growth in directory revenues; and reimbursement of its costs to produce and provide white pages directories to its customers."

  ⇒ The ICC also commented that, in negotiating the revised contractual agreements at that time, "... the corporate parent Ameritech has clearly demonstrated an inappropriate willingness to shift directory revenue from the regulated entity to the non-regulated entity through its manipulation of contractual arrangements."

- In response to a document request the Company states: "Beginning in January 2000 the cost plus subsidy arrangement ...was replaced with a billing and collection agreement and a listing and directory services agreement with Ameritech Publishing, Inc...."

Quantified Results of Investigation

1. BWG estimates that AI was overcharged $1.3 million in the first quarter of 2000 due to the use of an inappropriate method for the calculation of the 5 State Allocator. (Refers to Conclusion No. 5 and Exhibit AT-8)

Recommendations for the Company

1. Revise the method used to calculate the 5 State Allocator to more accurately determine the amount of affiliate billings. Allocation factors currently in use should be reviewed semi-annually to determine if adjustments are needed to reflect cost shifting attributable to the merger. (Refers to Conclusions 5 and 6)

2. To minimize the possibility of incorrect billings to affiliates, update AM 237, *Outline of Procedures for Interentity and Other Miscellaneous Billing*, to reflect current information. (Refers to Conclusion 10)

3. Complete the implementation of SBC OP 125 relating to Intellectual Property and Proprietary Information and develop a complete log of IP/PI exchanged in the merger. A complete analysis of this issue should be provided to the ICC when completed. (Refers to Conclusion 11)

Policy Issues for the Commission

1. In the proceedings relating to the review of merger cost and savings, determine whether or not AI is entitled to compensation relating to the exchange of Intellectual Property and Proprietary Information (IP/PI) and develop appropriate guidelines and reporting requirements for the Company to follow. Alternatively, confirm the Company's contention that the transfer of IP/PI between companies in the merger is a "like-for-like" exchange of property. (Refers to Conclusion 11)

Future Audit Issues

1. Include the examination of affiliate company allocation factors and billings in the scope of the Year 2000 CAM audit to ensure that they properly reflect organizational and operational changes following the merger. (Refers to Conclusion No. 6)

2. Expand the scope of the annual CAM audit to include an assessment of the Company's decision-making process relating to affiliate transactions. Documentation showing that the services needed are either not available or would be more costly if obtained from third party providers should support decisions in this area. (Refers to Conclusion No. 6)